

DEPARTMENT OF CORPORATIONS
California's Investment and Financing Authority

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Introduction

Affordable housing has been a perennial issue in California. Nontraditional mortgage products have created affordable financing arrangements with which to enter the California housing market. Many people have taken the introductory features of these products as a proxy for affordable housing. While the nontraditional mortgage products have eased entry into the housing market for many, they ultimately adjust to reflect the true cost of financing home ownership. As the use of these products expanded to subprime borrowers, consumers may be less able to afford the adjustment features these products carry, particularly in an environment where, as in today's market, refinancing options present challenges.

Increasingly in 2007, the California housing market has witnessed serious delinquencies and foreclosures. Most of these have been attributed to the increased sales of nontraditional mortgage products to subprime borrowers. The foreclosure starts appear to be more pronounced in inland areas where substantial new development has occurred.

Both the California Senate Banking, Finance, and Insurance Committee and the Assembly Banking and Finance Committee has held various informational hearings to assess the dimensions of foreclosure issues associated in the housing market, and the subprime segment of that market in particular. At these hearings, housing counselors and consumer advocates have stated that lenders and servicers were not making loan modifications for people who could afford to make regular payments. The lenders and servicers stated that they were making loan modifications. There has been no transparency as to what types of workout arrangements servicers are making available, and at what volumes. To assess whether modifications are being done in any meaningful measure, the Department of Corporations created a survey to send to its licensees to make them account for the rate of modifications being undertaken, and to measure other trends in the industry. These survey results, through September 30, 2007, appear together with this brief narrative.

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Survey Summary

In general, the survey results demonstrate that servicers are modifying loans at increasing volumes for consumers. In addition, servicers have increased the scale of their operations to match the increase of modifications they are undertaking. The results show, however, that even with more staff, the number of files for each full time employee (FTE) has increased since the beginning of the year. This means that more people are doing more work.

The projections of interest rate resets will escalate into the next year to proportions unmatched previously. There will be considerable stress placed on servicers as they will be required to accommodate increasing volumes of modifications or other workout plans. We cannot state with any certainty that the resets will result in a substantial increase in the number of foreclosures, but some additional delinquencies and foreclosures are inevitable, just as they are for rate resets associated with traditional ARMs. The volume of subprime rate resets presents a very large problem. Any solution will need to match the scale of that problem.

Nature of The Survey

The Department of Corporations (Department) has jurisdiction over state-licensed non-depository lenders and servicers. The Department developed a survey to issue to its licensees to capture data regarding various aspects of the loss mitigation market in California. The licensees were very helpful in assisting Department staff in developing the form, which borrows many definitions and categories from data fields used by the rating agencies for servicers.

The Department has been vaguely unsuccessful thus far in obtaining information regarding the California portfolios of servicers regulated by federal agencies, but we expect that may change over the course of the next few months. Even still, the Department believes the overall data we collected to be meaningful, and show trends that are likely consistent in the industry. For the servicers licensed by the Department, the responses represent over ninety percent of the loan volume, as measured by the 2006 year-end figures provided by residential mortgage lenders.

One final note on the survey itself is appropriate. We recognize there may be shortcomings in the form we used, but we expect refinements to occur over time. In fact, we are reviewing the form used by the State Attorneys Generals to determine if it is a superior information-gathering tool. The Department's survey was designed to capture relevant data regarding loss mitigation efforts, but to do so expeditiously. The survey results show the findings below.

Servicers Are Increasingly Making Modifications

Delinquent mortgage payments are handled by the loss mitigation staff in the loan servicing unit for most lenders. Some servicing units are stand alone operations, unaffiliated with a particular lender. Various workout alternatives exist for borrowers who cannot make timely mortgage payments. These alternatives include a temporary forbearance of some portion of the loan payments, modification of the loan to allow for regular payments on an affordable plan, refinancing the loan, if available, or a sale of the house by means of either a short-sale or deed-in-lieu.

The survey results demonstrate that from the beginning of the year, the number of workouts initiated per month has increased the most in the subprime sector. The increase has more than doubled from 7,800 to 20,500. The prime and Alt-A sectors have increased, to be sure, but not at the same pace.

In the workouts closed portion of the survey, the data shows that loan modifications have increased from 7% of the total workouts in the beginning of the year, to 19%. Since it takes time for the modifications to be completed, the overall modifications number should begin to trend higher as the number of workouts closed per month increases. Nonetheless, the current statistics indicate an increasing willingness of servicers to make loan modifications available for consumers who can make regular and acceptable monthly payments.

The importance of servicers' willingness to make loan modifications available to borrowers cannot be overstated. Aside from the small number of portfolio lenders, the Government Sponsored Entities, Fannie Mae, Freddie Mac, and FHA, are the main sources of mortgage credit in today's market environment. For subprime borrowers, or those whose loan characteristics do not meet any of the federal agency criteria, loan servicers represent the only real credit liquidity in the mortgage market. In many respects, the increased willingness of loan servicers to make modifications represents one of the final avenues for "refinancing" subprime mortgages in the current environment.

We note that the definition of modification has created a point of interest among servicers and consumer groups alike. For purposes of the survey, the Department uses modification to distinguish a long-term workout plan from a forbearance plan of relatively short duration. For securitized loans, some servicers consider plans for three to five years or longer to fit the definition of modification. Some servicers consider the term "modification" as one requiring a long term plan, of five years or longer. Consumer groups are interested in long-term affordability, and prefer use of the term modification as requiring a workout plan of at least five years in duration. For purposes of this initial report, we believe that most servicers use modification for plans of five years or more, but some have modifications of three years in duration. We are working on ways to address any potential inconsistencies for reporting the breakdown of workout plans.

Foreclosure/REO Inventories Have Increased

Lenders and servicers have represented that they do not want to become property owners. Yet, the data shows an increase in the volume of REO properties in servicers' inventories.

During one meeting the Department held with servicers, they stated that they have inquired into this aspect of the REO inventory, and learned that the reasons for these increases are due predominately to investor owned properties. That is, the investors who speculated on the real estate market have been the first to leave the properties to foreclosure rather than an alternative workout arrangement, if one were possible. That explanation is consistent with testimony economists have provided at various informational hearings.

The survey does not represent an event study on the relationship between foreclosures and interest rate resets or any other variables. Some servicers have indicated that the resetting of interest rates has not caused a spike in foreclosures, but instead the delinquencies and foreclosures are a function of poorly performing loans. Some of that may be true. The information captured in the survey shows that, as interest rates have reset on an increasing number of loans during the course of the year, there are a number of loans that are delinquent prior to the reset. For the subprime segment, the number of delinquent loans at the time of reset has increased from 2,300 to 4,000. Those that are current at the time or reset have increased from about 5,300 to 7,000.

There is a clear relationship between the initial interest rate resets and delinquencies, even for traditional ARMs. We would expect, therefore, delinquencies to continue to rise as rates begin to reset in more substantial volumes.

Forecast of Rate Resets

The volume of interest rate resets began to pick up appreciably commencing in June. The rate of resets over the next quarter will continue at the same pace, and begin to rise in December, and into next year. Experts predict the rate reset volume will crest sometime in March 2008, and remain high through the balance of that year and into 2009.

The character of the loans about to reset may change as well. Servicers have indicated that the resets for the 3/27 loans have begun in earnest this year, because those loans experienced high sales volumes in 2004-2005. The 2/28 loans were sold in more substantial volumes in late 2005 into early 2007. Everyone agrees that the 2006 and early 2007 vintages represent some of the weakest underwriting standards.

Taken together, this means that the work for mortgage servicing operations, in particular the loss mitigation units, will intensify to new levels. Loan modification decisions are essentially new underwriting decisions. Other workout arrangements involve equal time and consideration. Unlike the point of sale for these loans, there are no analogous wholesale or correspondent intake channels to assist with loss mitigation efforts. Loss mitigation staffing levels have increased. Countrywide announced that it expects to have a force of three thousand by the beginning of 2008. Although the loss mitigation staffing has increased, the staffing levels may not be enough to keep pace with the oncoming wave of rate resets. Even the current reset volumes have stressed staffing levels, with more FTEs working on an increasing number of files.

A Call For Systematic Workout Plans

Given the projections for resets, and the anticipated loss mitigation workload, the pace will quickly change, and the present way of approaching workouts may need to change. To that end, the Governor has announced an agreement reached with certain servicers to help speed up loan modifications. The principles of that agreement are on the Department's website. Last week, President Bush and the U.S. Treasury Secretary Paulson announced a plan that captures the spirit of those principles.

In his last speech before the U.S. Congress, Federal Reserve Bank Chairman Bernanke stated that the Fed is “already talking with servicers who are developing either computer programs or templates or procedures to allow them, at least as a first cut, to categorize mortgages in terms of how they are to be treated. ... [B]y providing a systematic approach to addressing these mortgages, they actually protect themselves against claims by investors or others who feel that they are arbitrarily changing or modifying the loans. So we do support scaling up these efforts, and the best way to do that is by creating some more systematic approaches to doing so.”

The Department supports efforts to find systematic solutions to the problems that homeowners and the industry face. Systematic loan modifications will free up resources in the loss mitigation departments to perform individual modifications for more difficult cases. We believe that, given the scale of this problem, no single solution may exist. Instead, various approaches will need to be found. We will work with the industry and all others interested to finding and effectuating such solutions.

In the meantime, the Department will submit updated versions of the survey results as they are received. The Department has requested receipt of these updates on a monthly basis.